



MEMORANDUM

To: Hans van der Velde

From: Ruth Pickford
EU Strategic Planning

Date: 15 May 1998

RE: DISCOVER CARD

I am unsure whether Michel Driessen has passed to you a copy of the attached draft presentation and assessment of Discover's international growth strategy and options, which has been developed by Visa Central.

A meeting is scheduled for next week between Central and the regions to discuss this paper for finalisation. The paper as it currently stands then does not reflect all of the regional comments.

Ruth Pickford

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Visa International Intelligence Assessment

Novus/Discover Goes International: How It Could Happen

Summary

In late 1997, executives at Novus/Discover have announced plans to create a global payments network in preparation for launching the Discover card overseas, and more recent press statements have reiterated this goal. It is unclear, however, how, how quickly, and with which partners they might do this. Novus/Discover faces formidable financial and logistical obstacles in expanding overseas, and is probably under pressure from Morgan Stanley Dean Witter to quickly improve its profitability. Given these financial and time constraints, Novus/Discover is likely to take a non-traditional, and less capital-intensive approach to entering the overseas market, and their public statements have alluded to such an approach. There are several different ways in which Novus/Discover could do this. Currently, we believe the most likely way is for Novus/Discover to build an overseas network through alliances with foreign banks or other institutions. Because the situation remains fluid, however, we have also outlined two other possible options that we believe are possible, albeit less likely.

Introduction

In February, Phillip Purcell, chairman and chief executive of Morgan Stanley Dean Witter (MSDW) told *The Financial Times* that MSDW plans to create a global payments network as a base for launching the Discover card worldwide. Purcell noted that Novus/Discover would first build an overseas network of merchants before issuing cards. This announcement followed earlier reports in *Cards International* that Novus is planning an overseas initiative.

Implications for Visa International

While an international venture by Novus/Discover is unlikely to significantly erode Visa International's market share in the near term, there are nonetheless several serious implications. If, for example, Visa's overseas member banks ally with Novus/Discover, this could have negative effects on Visa International's relations with these banks, or result in lost revenues, or lost cardholders. In addition, if Novus/Discover were to offer banks, merchants, or other potential partners significantly lower fees or transaction costs, or new service alliances with MSDW, these institutions may pressure Visa International to offer similar benefits. Finally, a major launch of Novus/Discover overseas could generate a considerable amount of media and industry attention and detract from Visa International's image as the premier global credit card.

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An Uncertain Relationship with MSDW

The coming year will be a crucial one for Novus/Discover. Approximately one year after the merger of Morgan Stanley and Dean Witter Discover, the future of Novus/Discover within MSDW remains uncertain. The accounting benefits of keeping Novus/Discover are due to expire within the next year, and within this timeframe MSDW will likely decide whether to retain and develop Discover as a long-term asset in its suite of products, or to exploit its access to Discover cardholders before selling the company. In the past, MSDW has shown a willingness to take resources away from underperforming businesses, and Novus/Discover will need to move quickly to avoid a similar fate. Already, the firm is taking moves to streamline its credit card operations: in the past two months alone, it has discontinued its Bravo card and sold SPS Transactions Services, Inc.

To date, MSDW and Novus/Discover have taken few actions to leverage the benefits of the merged firm. For its part, MSDW probably hopes that Novus/Discover will supply a steady revenue stream to offset the more volatile trading and investment banking businesses, and that MSDW can sell financial products to Discover's 40 million members. So far, however, Novus/Discover's financial performance has been disappointing, and as Morgan Stanley's CFO told *The Wall Street Journal*, "It will take a significant amount of time to understand whether we have a real gem here in these 40 million cardholders."

For Novus/Discover, the merger offers the possibility to target MSDW's more affluent customer base, or to take advantage of MSDW's global presence. In demographic terms, the Discover card fares comparatively well in this regard, belying the conventional wisdom that Discover has only "blue collar" appeal. In 1996, for example, it ranked second only to American Express in terms of cardholder income and the percentage of cardholders who are college graduates.

Company	Age	Income	Graduated College
Discover	43.2	\$74,038	29.0%
American Express	42.0	\$73,918	47.6%
Visa	44.5	\$54,113	26.8%
MasterCard	44.4	\$56,951	28.9%

Source: 1996 Analysis: General Purpose Cards

Discover's financial data, however, is mixed. Although it ranks above both Visa and MasterCard in average monthly expenditures and number of transactions, it lags behind the two associations in other key indices.

~~In addition, Discover's financial performance has been conspicuously poorer than that of the rest of the MSDW organization. Earlier this year, for example, MSDW announced a restructuring of its credit card operations to increase profitability.~~

Company	Avg. Mo. Expend.	Avg. Transaction	Avg. Rev. Balance	% of Cards with Balance	% of Transactions
Discover	\$565	\$110	\$1499	27.6%	5.1
American Express	\$565	\$110	\$1499	27.6%	5.1
Visa	\$339	\$73	\$2156	46.9%	4.6
MasterCard	\$356	\$74	\$2037	44.4%	4.8

Source: 1996 Analysis: General Purpose Cards

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In addition, Discover's financial performance has been conspicuously poorer than that of the rest of the MSDW organization, and prevented the firm from equaling its competitors' first-quarter results. First-quarter earnings from credit services, for example, dipped 21% from 1997, compared to a 31% increase in MSDW's securities business. Partly as a result, MSDW recently announced a restructuring of its credit card operations to increase profitability.

Looking Overseas For an Answer

Facing pressure from MSDW, disappointing financial performance, and diminishing market share in the US, Novus/Discover has turned its sights on the international market. The company, however, faces a number of significant obstacles. Given the above constraints, Novus/Discover needs to satisfy two potentially contradictory requirements: to demonstrate results quickly, and to do so at a relatively low cost. We believe this eliminates the approach that Novus/Discover used to build its network in the US, and that Novus/Discover will use a non-traditional approach to enter the international market.

We believe the most likely option is for Novus/Discover to build its international approach through alliances with large banks or other partners in each country it chooses to enter. Because the situation remains fluid, however, we have also outlined two other possible options that we believe are possible, albeit less likely. These three options should not be considered mutually exclusive.

Option #1: Build a Network Through Alliances

Under this option, Novus/Discover would offer banks or other institutions the right to be Novus/Discover's exclusive representative in a specific country. In this way, Novus/Discover could build its overseas network on a country-by-country basis. This is perhaps the quickest way for Novus/Discover to show results without incurring prohibitive costs, nor significantly altering its operating model. This approach would be similar to that used by American Express in parts of Western Europe, and by JCB in major Japanese tourist destinations.

To make this option attractive to potential partners, Novus/Discover could offer them the option of issuing either the Discover or Private Issue cards, or the bank's own cards on the Novus network. In fact, a Novus executive vice president alluded to such an overseas arrangement in an interview with *Cards International*. "And we are not saying that those banks have to issue the Discover card. XYZ bank may want to issue its own brand of card—to build that brand, to invest in the brand and then issue the card for use over the Novus network, as opposed to issuing an XYZ Novus/bank card as you have to do with the associations and Amex today. We believe that is a critical difference in our approach compared to our competition."

Alternatively, Novus/Discover may ally with other firms who can provide an international network. There may be an opportunity, for example, to utilize MSDW's existing international infrastructure and customer base. Similarly, alliances with large, multinational data processors, such as EDS or FDR, or with emerging service providers like Thomas Cook, or with other non-traditional partners such as telecommunications firms, could be another way for Novus/Discover to overcome some of the structural hurdles to entering the international market.

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There are several obstacles to this approach. First, unless banks or other potential partners are allowed to issue their own cards, they may be reluctant to introduce lesser-known cards, such as Discover or Private Issue. This may be especially true for banks that already issue either Visa, MasterCard, or American Express cards; they may feel that the Discover cards offer no significant advantages over the other cards. Additionally, Novus/Discover would also risk losing the direct contact with merchants and customers that it enjoys in the US, and foreign banks may insist on charging merchants higher fees than Discover, thus undercutting one of Discover's primary selling points.

Potential Indicators That Novus/Discover is Pursuing This Approach

In advance of a public announcement, there are several potential indicators that could provide early warning that Novus/Discover is pursuing this approach:

- Information that Novus/Discover is proposing alliance discussions with foreign banks could surface from Visa International member banks.
- Information could surface from financial analysts or industry experts that Novus/Discover is in discussions with other organizations with an international network.
- Novus/Discover may speak to financial analysts to gauge their receptiveness to such a strategy.
- Novus/Discover may try to get advanced reaction from merchants, customers, and industry observers through preliminary press "teasers."

It would, however, be much more difficult to determine beforehand if Novus/Discover plans to use MSDW's international infrastructure, since such internal discussions are likely to be very closely held.

Option 2: Leverage the Merchant

In this approach, Novus/Discover would build and leverage relationships with major retailers in order to build its overseas presence. This would allow merchants to either issue their own cards, which would utilize the Novus network, or issue a co-branded card with Discover. Such an approach may be particularly well-suited to Western Europe, where merchants cards are more common than in the United States, and where the relationship between merchants and card-issuing banks are less cordial than in the United States. In speaking to *The Financial Times*, in fact, MSDW Chairman Purcell said the bank would start its overseas initiative "by building a global network of merchants who would accept its cards, possibly through partnerships in each country."

This approach would offer several potential benefits to merchants. First, Discover has traditionally charged merchants less than other major credit cards, and could continue to do so overseas. Second, by issuing their own cards, merchants would have a greater potential to build their brand equity with customers. Third, since Novus would maintain sole control over the customer charge and approval network, it could offer merchants detailed analyses of their customers' demographic information, buying preferences, and purchasing behavior—something neither Visa nor Master Card currently provide. Finally, merchants would potentially be able to negotiate and sign a single, world-wide processing agreement with Novus, rather than separate agreements with issuing banks in each country.

On the negative side, this approach could place much of the infrastructure cost on Novus/Discover, and would take some time to accomplish. It would, for example, require considerable financial investment

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for Novus/Discover to expand its existing network overseas. While MSDW appears to have the resources for such an undertaking, it is unclear if MSDW is willing to invest this money in Novus/Discover.

Alternatively, Novus/Discover could find a way to utilize existing data networks overseas. Public statements by Novus/Discover executives, in fact, have alluded to non-traditional network partners, such as mutual fund companies, and software or telecommunications firms.

Potential Indicators That Novus/Discover is Pursuing This Approach

In advance of a public announcement, there are several potential indicators that could provide early warning that Novus/Discover is pursuing this approach:

- Information that Novus/Discover is proposing alliance discussions with foreign merchants could surface from Visa International member banks.
- Information that Novus/Discover is investing in specialized software, hardware, personnel, or consulting could surface.
- Information that MSDW is willing to provide Novus/Discover with significant capital for such a move could surface from financial analysts.

Although it would be somewhat difficult to spot indications that Novus/Discover is currently speaking with overseas merchants, this approach would likely be done in a piecemeal fashion, giving Visa International greater time to react after the first merchant alliance is announced.

Option #3: Join or Ally With an Existing Network

In this approach, Novus/Discover would join with an existing network provider, such as MasterCard, American Express, or ~~Diner's~~ Diners Club as a way to enter the international market. This would allow Novus/Discover to expand overseas quite rapidly, at a comparatively low cost.

This option would afford a number of benefits. First, American Express or ~~MasterCard~~ Diners Club would certainly benefit if they were allowed access to the Novus/Discover acceptance network in the United States in return for a reciprocal agreement overseas. In addition, the market share of any potential partner would increase dramatically if Novus/Discover were to join their network. For Novus/Discover, such a deal would provide immediate acceptance overseas, and allow the company to issue its own cards in each country.

On the downside, American Express, MasterCard, and ~~Diner's~~ Diners Club are competing for many of the same markets overseas that Novus/Discover is likely to target. American Express, in particular, is making a concerted effort to appeal to the types of younger, middle-income customers that the Discover card tends to attract. It is also unclear if MSDW would sanction an alliance with American Express—one of its chief competitors in the financial services market. For MasterCard, a potential alliance with Novus/Discover overseas could raise fears of undermining MasterCard's legal position in the US with the Department of Justice.

For its part, Novus/Discover would have to undergo a significant shift in its corporate approach. The company has been fiercely independent since its founding, and seems to revel in challenging its larger competitors. In addition, in joining with another card issuer, Novus/Discover would likely have to

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accept the existing relationship with merchants, thus undercutting the lower-fee approach that it pioneered and still trumpets.

A variation on this approach could also emerge if Novus/Discover entered into a reciprocal agreement with a foreign card issuer like JCB. For example, Novus/Discover could offer JCB access to the Novus acceptance network in the United States in return for access to JCB's networks in Asia and Europe. While such an approach would give Novus/Discover relatively quick and inexpensive access to these markets, it would also require that the company spend considerable time and money to develop them. Because the Discover cards are almost unknown in Europe and Asia, Novus/Discover would have to expend considerable resources to develop its brand, or to market it through MSDW's existing overseas client base.

Potential Indicators That Novus/Discover is Pursuing This Approach

We believe that it will be very difficult to determine beforehand if Novus/Discover is pursuing this approach. Discussions with potential alliance partners are likely to be held at the very highest levels of both companies, and information will be closely held. Even if information surfaces that such discussions are occurring, it will be difficult to gauge the receptivity of the other party to the Novus/Discover offer.

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